LE COPY

Office-Supreme Court, U.S.
FILED
FEB 17 1962
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 224

THE HANOVER BANK, EXECUTOR, ET AL.,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

JACOB A. and BERTHA L. GOLDFARB,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONERS

THEODORE TANNENWALD, JR.,
60 East 42nd Street,
New York 17, New York,

DAVID ALTER,
32 East 57th Street,
New York 22, New York,
Attorneys for Petitioners.

Of Counsel:

MARTIN D. GINSBURG
WEIL, GOTSHAL & MANGES
SQUADRON, ALTER & WEINRIB

INDEX

PAGE

ARGUMENT:

I. Respondent's argument that the question involved herein is the meaning of "earlier call date" rather than "amount payable" is inconsistent and illusory 2

II. Respondent's theory, that a second amortization of bond premium may be had to the special call price upon an actual special call, is directly opposed to his own regulations 7

III. Although petitioners contend that Section 125 is clear on its face, the legislative history of that Section, contrary to respondent's assertions, also directly supports amortization of bond premium to the special call price and date 10

IV. Respondent cannot escape the effect of his own prior rulings 13

V. Respondent continues to evidence unequal application of his theories even as between taxpayers who never received private rulings 15

CONCLUSION 15

CITATIONS

Cases:

Commissioner v. *Korell*, 339 U. S. 619 (1950), *affirming* 176 F. 2d 152 (2d Cir. 1949), *affirming* 10 T. C. 1001 (1948) 2, 4, 5-6, 10-11

Gallun v. *Commissioner*, F. 2d , 62-1 U.S.T.C. para. 9153 (7th Cir. 1961), *reversing* 1960—104 T. C. Memo. 15

Helvering v. *Griffiths*, 318 U. S. 371 (1943) 14

Helvering v. *R. J. Reynolds Tobacco Co.*, 306 U. S. 110 (1939) 8

PAGE

Mastro Plastics Corp. v. *NLRB*, 350 U. S. 270 (1956) 12

Schwegmann Bros. v. *Calvert Distillers Corp.*, 341 U. S. 384 (1951) 12

Statutes:

Int. Rev. Code of 1939 (26 U.S.C., 1952 ed.):

Sec. 125 ..... *passim*

Sec. 3791(b) 13-14

Int. Rev. Code of 1954 (26 U.S.C., 1958 ed.):

Sec. 171 8

Sec. 7805(b) 14

Regulations:

Treasury Regulation 118 (1939 Code):

Sec. 39.125 (b)-2(a) (1953) 8

Sec. 39.125 (b)-5 (1953) 9

Treasury Regulation Sec. 1.171-2(b)(2) (1954 Code) adopted December 5, 1957 by T. D. 6278, 22 F. R. 9880 8

Congressional Committee Reports and Legislative Materials:

Testimony of Roy C. Osgood: Vol. 2, Hearings Before the Committee on Finance, United States Senate, on H. R. 7378, 77th Cong. 2d Sess. 1729 (1942) 10-11

Staff Summary of H. R. 8300:

Part I, Hearings Before the Committee on Finance, United States Senate, 83d Cong. 2d Sess. 21 (1954) 11-12

Internal Revenue Rulings:

Rev. Rul. 56-398, 1956—2 Cum. Bull. 984 ..... 7, 13, 15

IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 224

THE HANOVER BANK, EXECUTOR, ET AL.,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

JACOB A. and BERTHA L. GOLDFARB,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONERS

This reply brief is filed by petitioners, in response to the brief for respondent, in order to correct certain statements and answer specific arguments in respondent's brief. This reply brief is also utilized to present one new matter, a case decided since the filing of petitioners' main brief.

I

Respondent's argument that the question involved herein is the meaning of "earlier call date" rather than "amount payable" is inconsistent and illusory.

Petitioners, in their main brief (Pet. Br. 2), have characterized the question presented herein as being whether the special call price is an "amount payable on . . . earlier call date" within Section 125 of the Internal Revenue Code of 1939. This is in line with the past history of litigation in this area, notably the three court decisions in *Commissioner* v. *Korell*.[1]

Respondent has long agreed with this Court's necessary finding in *Korell* that the words "earlier call date" mean "earliest call date" and encompass the 31st day after purchase of thirty-day callable bonds.

Quite properly discouraged by the results of past litigation considering the "amount payable" wording of Section 125, respondent in his brief (Res. Br. 2, 15) has announced that the question here turns, not "upon the interpretation of the statutory phrase 'amount payable' but upon the interpretation of 'earlier call date'" (Res. Br. 45). At the same time, respondent concedes the correctness of two arguments made by petitioners: the economic likelihood of redemption at the special call price is of no significance under Section 125 (Res. Br. 16), and the question of whether the special call price is a permissible base for amortization of bond premium under Section 125 must be settled by a general rule applicable to all cases (Res. Br. 16).

---

1. 339 U. S. 619 (1950), *affirming* 176 F. 2d 152 (2d Cir. 1949), *affirming* 10 T. C. 1001 (1948), all decided in favor of the taxpayer.

Respondent's proposed general rule, purporting to distinguish the general call from the special, seems to be as follows:

> 1. A thirty-day general call provision, in and of itself, *always* qualifies as giving rise to an "earlier call date" since the bond issuer had the legal right to call 100% of the issue at the general call price on 30 days notice.
>
> 2. A thirty-day special call provision, in and of itself, *never* qualifies as giving rise to an "earlier call date" since the bond issuer does not normally have the legal right to call 100% of the issue at the special call price on 30 days notice. It can normally call a percentage as of right plus more, or even all, of the issue at the special call price only upon the happening of certain stated contingencies — and, therefore, as to any one particular bond, the issuer cannot be guaranteed its right of redemption at the special call price.

Respondent's position, then, quite simply, is that "call date" does not mean a date upon which bonds can be called unless they can all be called at the same time.

Respondent thus places his reliance on "legal rights" or, perhaps more properly, on the alleged lack of legal rights —the alleged lack of the issuer's legal right to call any particular bond at the special call price on 30 days notice, and thus the alleged lack of the issuer's right or power to deprive the owner of a particular bond of the premium he has paid on that bond over its special call price. Respondent, in order to create the general rule he concedes is required under the statute, makes it clear that he would deny special call amortization even if the issuer had the right to call 99% of all bonds at the special call price on 30 days notice (Res. Br. 26-27). Nothing less than 100%

will do for respondent, and nothing less than 100% can do if respondent is to have a general rule, all parties having agreed a general rule is required under the statute.

Let us examine respondent's theory in light of Section 125 and its judicial history.

In *Commissioner* v. *Korell*, *supra*, this Court considered the propriety of amortizing bond premium where the bond was callable on 30 days notice at 104. In the year in issue, the taxpayer's bonds were not called. The bonds were convertible in that year, at the option of the holder. The taxpayer had purchased his bonds at approximately 121 (the premium thus being approximately 17 points above the call price), with the high premium being almost entirely attributable to the conversion feature of the bonds. Respondent argued that this type of premium was not "true" bond premium and should not qualify for the amortization benefits of Section 125. Respondent's argument was rejected by this Court and by the two lower courts.

The *Korell* situation is most significant in analyzing the position of respondent in the instant cases. Respondent tells us that unless the bond issuer has the legal right to call upon thirty days notice so as to deprive each and every bond and each and every bondholder of premium in excess of the special call price, the special call cannot qualify within the statute. Respondent concedes that at least 1% of the bonds in the instant cases could have been redeemed by the issuer at the special call price as of right. Indeed, respondent is disingenuous on this point. The fact of the matter is that, although the issuer was limited to deposits of 1% in any given year, it did not have to redeem every year. The issuer could have permitted its deposits to accumulate over a period of years before exercising its right of redemption at the special call

price. Consequently, if, for example, the accumulations covered a period of 10 years prior to redemption, the chance of a given bond being redeemed out of such funds became 1 out of 10 instead of 1 out of 100 as respondent claims. Respondent further concedes that based on contingencies either outside the issuer's control or within its control but onerous upon it (Res. Br. 44) more and perhaps all of such bonds could have been redeemed by special call, but respondent nevertheless remains of the opinion that Section 125 requires a 100% legal right, absolute and uncontingent.

Respondent has forgotten, or chooses to overlook, the fact that, in *Korell*, the issuer could not deprive *any* bond or bondholder of premium above the call price unless the bondholder was willing to let the issuer do so.

As the Tax Court's findings of fact in *Korell* make clear (10 T. C. 1001, at 1002), if the issuer called the bonds, the bondholder had the "legal right" to convert out from under the call at any time prior to the close of business on the date otherwise fixed for redemption. Since the bond premium was tied to the price of the conversion security—to the shares obtainable upon conversion—the taxpayer by converting would have retained his premium. A sale of the conversion security immediately thereafter would have provided a complete recoupment of the taxpayer's investment, premium and all.

Respondent may argue that the "legal right" of Mr. Korell to protect his premium by converting out from under a call did not affect the "legal right" of the issuer to call. However, "legal right" can be significant only if respondent is willing to consider *all* of the legal rights created by the bond indenture. On this basis, respondent must conclude that *Korell* is wrongly decided, upon his

theory that the issuer did not have the legal right to redeem all of the bonds.

Section 125, in referring to "earlier call date", has reference to the earliest redemption date which could be specified in a notice of call. In *Korell* the issuer could *call* as of right 100% of outstanding bonds, but could *redeem* as of right, on the "earlier call date", none. In the instant cases, the issuer could call at least 1% of outstanding bonds at the special call price—and, depending upon various contingencies both within and without his control, could call a much greater percentage at that price—and could redeem, on the "earlier call date", each and every bond called.

If the 30 day redemption date was an "earlier call date" in *Korell, a fortiori* the 30 day special call redemption date was an "earlier call date" in the instant cases. As it was not significant that the issuer could not redeem any particular bond in *Korell,* it is at least equally insignificant in the instant cases.

The inconsistency and illusory nature of respondent's argument is obvious. In both bond issues involved herein, the right to redeem the bonds on thirty days notice at the special call price in the taxable year in question was present. It was present because the bond indentures said so in so many words. It is true that certain conditions had to occur before the right could be exercised. But even respondent admits that they could have occurred. Thus he characterizes the right to use the 1% annual deposits as "limited" (Res. Br. 10, 26, 35) and the right to use the so-called "property funds" as "contingent" (Res. Br. 43). By these characterizations, respondent reveals the inappositeness of his example of a bond which is callable at the end of ten years (Res. Br. 13); in such a case, no combination of events could bring the right

of redemption into being until the ten-year period had expired.

Thus respondent is inevitably remitted to the issue of "likelihood," despite his protestations to the contrary. Once this point is reached it becomes apparent that the conceded right to amortize to the general call price goes hand in hand with the right to amortize to the special call price. The occurrence of a redemption at the general call price is dependent upon one set of events— the fluctuations in the interest market; the occurrence of a redemption at the special call price is dependent upon another set of events—deposits in the sinking fund by the issuer over one or more years, takings by Governmental agencies through eminent domain, destruction of the property securing the bonds, etc. In either case, the events could happen; at any given moment the actual likelihood that they would happen could just as easily be greater with respect to the special call price than with respect to the general call price. Thus there is no reason to apply the rule of "generality of the cases" in one case rather than the other.

II

Respondent's theory, that a second amortization of bond premium may be had to the special call price upon an actual special call, is directly opposed to his own regulations.

On page 28 of his brief respondent, relying upon the closing portion of his Rev. Rul. 56-398, 1956—2 Cum. Bull. 984, 987, conjures up an "equitable solution" to the dilemma which would be created by adoption of his "never amortize to the special call" theory. Respondent would allow the taxpayer to amortize premiums on a 30 day

basis to the general call price. Thereafter, when and if the bonds were later called at the special call price, respondent would permit the taxpayer an immediate second amortization to that lower price.

This is an interesting theory, certainly. It first saw the light of day in respondent's 1956 ruling. It is now supported by the words of his Treas. Reg. §1.171-2(b)(2), adopted December 5, 1957 by T. D. 6278, 22 F. R. 9880.

Unfortunately, the theory did not exist in 1953, the year in issue here, and it could not have existed—the applicable Treasury Regulations were directly opposed:

> "A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium." Treas. Reg. 118, Sec. 39.125(b)-2(a) (1953)

This language no longer appears in the regulations, having been superseded through the adoption of T. D. 6278 in 1957.

Thus, by attempting here to apply his 1956 ruling retroactively to petitioners, respondent is in reality attempting retroactively to amend his very clear 1953 regulations. Moreover, he is attempting retroactive amendment only as to some taxpayers (those who did not request private rulings) but not as to others (who did request rulings).

Can respondent do this? No, he cannot, for here we are dealing with a clear statement which was in the regulations when Congress reenacted the statute in 1954 as Section 171 of the 1954 Code. In this situation, Congressional reenactment bars retroactive change in the regulations. See, *e.g.*, *Helvering* v. *R. J. Reynolds Tobacco Co.*,

306 U. S. 110 (1939) and cases cited at page 39 of petitioners' main brief.

In his brief (p. 28), respondent tells us that "petitioners' method" cannot be justified on the ground that the choice is amortization for all or—under respondent's theory—for no bonds at all, for, says respondent, there is the easy choice of two different amortizations of the same bonds by the same holders at two different times. Respondent is incorrect. No such choice was available, for respondent's own regulations specifically forbade it.

In addition respondent's 1953 regulations further state (Regs. 118, Sec. 39.125(b)-5):

> "The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, *or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer.*" (Italics supplied.)

These regulations make it crystal clear that the taxpayer was entitled to pick *any* call date specified in the bond. Whatever respondent may think, the thirty-day call provision was a call date within the literal language of this provision, and petitioners complied therewith by selecting the special call date.

III

Although petitioners contend that Section 125 is clear on its face, the legislative history of that section, contrary to respondent's assertions, also directly supports amortization of bond premium to the special call price and date.

Petitioners assert that Section 125 is determinative of their right to amortize down to the special call price. Petitioners buttressed this position by elaborating in detail on the legislative history (Pet. Br. 21-25). Respondent, however, deprecates this history and seeks to lead this Court into believing that Congress never had any idea, either in enacting or in amending Section 125, that taxpayers might consider amortizing bonds to a lower special call price—or indeed, that Congress had any idea that any bonds even had a special call price (Res. Br. 34-38).

In their main brief, petitioners pointed out two occasions in which Congress did consider the special call price under Section 125 (Pet. Br. 21-25).

First, petitioners noted the testimony of Roy C. Osgood before the Senate Finance Committee during the 1942 hearings leading to the enactment of Section 125 (Pet. Br. 24-25). Respondent concedes (Res. Br. 36) that Mr. Osgood raised the very question of a special call which is involved here. However, respondent finds the fact that this very question was raised to be insignificant, and suggests that Congress may have paid no heed at all to Mr. Osgood.

This is cavalier treatment indeed for the "farsighted" Mr. Osgood (to use respondent's terminology). This Court, at least, has thought far more of him in the past. In *Commissioner* v. *Korell*, 339 U. S. 619 (1950), consider-

ing the applicability of Section 125 to callable-convertible bonds, this Court noted at page 623:

> "The role of such bonds was specifically brought into the congressional discussion by at least one witness at the hearings[4]."

The footnote identifying the witness reads:

> "4. See statement of Roy C. Osgood, 2 Hearings before Senate Committee on Finance on H. R. 7378, 77th Cong. 2d Sess. 1728-29 (1942)."

The statement of Mr. Osgood on special call bonds appears at page 1729 of the cited volume, the very page upon which his statement on convertible bonds appears. We submit that the significance of Mr. Osgood's "far-sighted" comments is no less in the present cases than it was in the *Korell* case.

Second, petitioners noted (Pet. Br. 23-24) that the staff of the Joint Committee on Internal Revenue Taxation, in summarizing the Bill which became the Internal Revenue Code of 1954, illustrated the workings of Section 125 of the 1939 Code by using the special call price then current in Appalachian Electric Power Company 30-year 3.75% Bonds. As the staff did not name these Bonds but merely gave all pertinent figures, respondent (Res. Br. 36-37) dismisses the staff report as insignificant on the grounds that only "petitioners' thorough research" has uncovered the fact that the staff was referring to a special call price, and that it was unlikely that any member of Congress had been equally diligent in research or otherwise knew that a special call price was being referred to.

Respondent is overly kind to petitioners. No thorough research—indeed, no research at all—was required. The Appalachian Bonds were not merely one of many popular

issues of 30-day callable bonds, as respondent suggests (Res. Br. p. 37). They were the very bonds at issue here in the *Gourielli* case. More important, during the early 1950's they were well known as the prime example of 30-day tax benefit bonds—a fact which respondent's counsel himself brought out in the Tax Court hearing in *Gourielli* when he referred to the Appalachian bonds as "tax gimmick bonds" (Tr. 10).

In the portion of his brief devoted to legislative history —and this is particularly noticeable in his reference to the testimony of Mr. Osgood (p. 36)—respondent seems to indicate that particular events of legislative history take on importance only if "Congress"—in effect the whole of the body—paid heed to these events. This is not the law. This Court has long held that pertinent legislative history is the statements made to and by the very few legislators who were active in and in favor of the promulgation of the particular statute. See, *e.g.*, *Schwegmann Bros.* v. *Calvert Distillers Corp.*, 341 U. S. 384, 394-395 (1951); *Mastro Plastics Corp.* v. *NLRB*, 350 U. S. 270, 288-289 (1956).

In tax legislation, the pertinent legislators are unquestionably the members of the House Ways and Means Committee and the Senate Finance Committee who are active in support of a bill. It was to the Senate Committee that Mr. Osgood spoke. It was to these key Congressional committees that the Staff Summary of H. R. 8300 was addressed. From the viewpoint of relevant legislative history, the comments of Mr. Osgood and the illustration by the staff were addressed to the only persons in Congress whose knowledge was significant.

Moreover, in endeavoring to interpret Section 125, respondent has inconsistently treated the provision of that Section dealing with the determination of a "reasonable"

method of amortization. On the one hand, respondent seeks to buttress his argument as to Congressional intention by referring to this provision (Res. Br. 27). On the other hand, he dismisses without explanation petitioners' reliance on this very same provision to support their position that the earlier rulings of respondent as to the use of the special call price were persuasively in keeping with the intent revealed by this same provision (Res. Br. 41).

IV

Respondent cannot escape the effect of his own prior rulings.

Petitioners have noted that for many years prior to his 1956 ruling, respondent consistently ruled that amortization to the special call price was proper (Pet. Br. 8). Respondent disclaims the applicability of those rulings by asserting that petitioners did not receive any rulings addressed to them and therefore the prior rulings are immaterial (Res. Br. 38-42).

Respondent misses the point. Petitioners do not rely primarily on the private rulings *per se*. They do, however, assert that, if for any reason, this Court believes that the language of Section 125 is not clear on its face, respondent's contemporaneous rulings at the time of the transactions herein are persuasive evidence as to the proper interpretation of Section 125.

Petitioners further assert that the fact that these rulings were widely publicized in financial circles and in tax services is important in determining whether respondent's reversal of position in 1956 should properly be allowed to operate retroactively under Section 3791(b)

of the Internal Revenue Code of 1939 or its successor, *in haec verba*, Section 7805(b) of the Internal Revenue Code of 1954. These sections were intended to be a shield for taxpayers and not a sword as respondent would have this Court believe. In *Helvering* v. *Griffiths*, 318 U. S. 371, 397 n. 49 (1943), this Court, in commenting on Section 3791(b), put the case in words peculiarly apt in the present situation:

> "Thus it appears that this legislation was intended to permit escape from the retroactive effects of administrative action by the Treasury, rather than to increase its power to make retroactive rulings.
>
> "We are asked to make a retroactive holding that for some seven years past a multitude of transactions have been taxable although there was no source of law from which the most cautious taxpayer could have learned of the liability."

Finally at page 39 n. 10 of his brief, respondent has asserted that no claim of reliance upon respondent's prior favorable letter rulings has been made in the instant cases. Respondent is factually incorrect. In the *Gourielli* case a major portion of the testimony adduced before the tax court was for the purpose both of claiming and proving such reliance (Tr. 13-19). Copies of private letter rulings of the type so relied upon are in the instant record, having been introduced into evidence in the Tax Court by petitioner (Tr. 53-65).

V

Respondent continues to evidence unequal application of his theories even as between taxpayers who never received private rulings.

At note 27 to pages 44 and 45 of their main brief, petitioners have pointed out that respondent has not consistently applied the position adverse to special call amortization which is announced in his 1956 revenue ruling. Four recent examples of this inconsistency were pointed out.

Since the filing of that brief, a fifth example has appeared, *Gallun* v. *Commissioner*, F. 2d , 62-1 U.S.T.C. para. 9153 (7th Cir. Dec. 31, 1961), *reversing* 1960—104 T.C. Memo. Five separate bond issues were involved. In each case the taxpayer amortized to the special call price and in no case did the government take exception to the amortization merely because it was to the special call price. No private rulings had been issued. The Seventh Circuit validated the deductions for bond premium amortization.

Conclusion

Throughout his brief, respondent places primary reliance upon a novel theory indeed—that "call date" in the statute does not mean a date upon which bonds can be called unless they can *all* be called on that date. Only an absolute uncontingent right to call 100% of all bonds—not merely 99%—will satisfy respondent's test. Respondent is so enamored of his unusual theory that he has chosen to place sole reliance upon it: he has conceded petitioners' argument that a general rule must be adopted

applicable to all bonds and all issues; he has conceded petitioners' argument that the economic likelihood of a call at any particular price or date is insignificant; and he has not chosen to contest petitioners' position that the special call price is an "amount payable" within the meaning of the statute.

Petitioners would conclude with a simple over-all comment: it is almost inconceivable that Congress would have adopted the "100% absolute and uncontingent" theory which has been put forth by respondent; there is not the slightest shred of evidence that Congress ever even imagined such a theory; and there is absolutely nothing in the judicial history of Section 125 which in any way supports respondent's theory. Quite simply, respondent has created his theory, all by himself and full blown for the occasion, out of the whole cloth.

For the reasons stated, the judgment of the court of appeals should be reversed.

Respectfully submitted.

THEODORE TANNENWALD, JR.,
DAVID ALTER,
Attorneys for Petitioners.

Of Counsel:

MARTIN D. GINSBURG,
WEIL, GOTSHAL & MANGES,
SQUADRON, ALTER & WEINRIB.